VERMONT GAS SYSTEMS, INC.
ATTACHMENT 1

RATE SETTING
EARNINGS SHARING MECHANISM

The rate setting formula consists of three steps involving the determination of:

- The Revenue Cap in accordance with a predetermined escalation formula;
- The Required Revenue; and
- Rates based on a comparison of the Required Revenue with the Revenue Cap.

Revenue Cap

The Revenue Cap will be determined as follows:

$$REV_{Ct} = OC_{Ct-1} * (1+INFLATION-X) * CUSTOMERS_t + NON\text{-}OPERATING\ COSTS_t \pm EXOGENOUS\ FACTORS \pm EXCLUSIONS$$

Where:

REV_{Ct}	=	Revenue Cap for rate year t
OC_{Ct-1}	=	Operating Cost Cap for rate year t-1
INFLATION	=	(see below)
X	=	(see below)
$CUSTOMERS_t$	=	Projected customers for rate year t
EXOGENOUS FACTORS	=	(see below)
EXCLUSIONS	=	(see below)
$NON\text{-}OPERATING\ COSTS_t$	=	(see below)

Operating Cost Cap In the first year of the plan, the Operating Cost Cap will be equal to the operating costs per customer authorized by the Board based on VGS's cost of service filing for that year. Thereafter, in each subsequent year of the plan the Operating Cost Cap will be determined by applying the formula (1+INFLATION-X) to the previous year's Operating Cost Cap.

Inflation The inflation factor in the Revenue Cap formula will be based on the historical rate of inflation for New England for the most recent 12 months ending before VGS's rate filing. Inflation will be based on CPI data for Northeast published by the US Dept of Labor – Bureau of Labor Statistics.

X Factor Under the Operating Cost Cap, the X Factor is based on an estimate of the historical performance of VGS during the 5 years ending 2004.

The X Factor adopted is .39%

Customers VGS will prepare a forecast of the average number of customers during the rate year.

Non-Operating Costs Non-Operating Costs for the Revenue Cap formula will be based on VGS's budget for the rate year and will comprise all cost-of-service components (other than Gas Costs) not covered by the Operating Cost Cap, including depreciation, amortization, property taxes, income taxes, other taxes, return on rate base, interest expenses, and other income.

Exogenous Factors Exogenous Factors are events beyond the control of VGS, which affect its costs and the inclusion of which in rates is justified. Examples of Exogenous Factors include decisions of regulatory bodies or governments, or changes in accounting guidelines. To trigger a rate adjustment, an Exogenous Factor will meet the following criteria:

- It cannot be under the control of VGS; and
- It must apply specifically to VGS's field of activity rather than to the economy as a whole.

There will be no minimum threshold for incorporating the monetary impact of an Exogenous Factor in the performance incentive mechanism.

Exclusions Exclusions are items that affect VGS's costs and which are under VGS's control. As with Exogenous Factors, there is justification for including the full impact of Exclusions when setting rates.

Exclusions serve two main objectives:

- To avoid creating an incentive to avoid expenses, which would otherwise be considered desirable. For example, demand side management expenses would be treated as an Exclusion.
- To adjust rates for Over-earnings or Shortfalls (see below).

There will be no minimum threshold for incorporating the monetary impact of an Exclusion in the performance incentive mechanism.

Required Revenue

Required Revenue will be determined in the same manner as under a traditional cost-based regulatory framework. Accordingly, a budgeted estimate based on the forward test year will be supplied by VGS in each rate application and will deal with the following items:

- Operating expenses;
- Depreciation;

- Amortization;
- Property and other taxes;
- Deemed income taxes;
- Return on projected rate-base (13-month average);
- Other income

The return on rate base will correspond to the average cost of capital for the various components of the capital structure as authorized by the Board.

<u>Rates based on a comparison of the Required Revenue with the Revenue Cap</u>

The formula for setting authorized rates will differ depending on the comparison of the Required Revenue with the Revenue Cap.

Required Revenue < Revenue Cap

If the Required Revenue is lower than the Revenue Cap, then rates will be set so as to generate the Revenue Cap less 50% of the difference between the Revenue Cap and the Required Revenue.

$$REV_{At} = REV_{Ct} - (.5 * (REV_{Ct} - REV_{Rt}))$$

Where:

REV_A	=	Authorized Revenue for rate year t.
REV_C	=	Revenue Cap for rate year t.
REV_R	=	Required Revenue for rate year t.

Authorized revenues per customer will be calculated based on the projected average number of customers for the rate year.

Required Revenue > Revenue Cap

If the Required Revenue is greater than the Revenue Cap, then rates will be set to generate the Required Revenue:

$$REV_{At} = REV_{Rt}$$

In addition:

- Excess for the rate year will be calculated as $REV_{Rt} - REV_{Ct}$.
- Productivity gains (i.e., cases where Required Revenue is less than the Revenue Cap) in any subsequent year will be applied to reduce rates (i.e., before any sharing) until all such Excess is offset; and

- Any Over-earnings (see below) in subsequent years will be applied to reduce rates (before any sharing) until all such Excess is offset.

Sharing at Year-End Review

At the end of the rate year, Over-earnings (if any) or Shortfalls (if any) will be calculated by comparing the actual return to the authorized rate or return.

$$OE = E - E_A$$

$$SF = E_A - E$$

Where:

OE	=	Over-earnings
SF	=	Earnings shortfall
E	=	Actual earnings
E_A	=	Allowed earnings based on authorized rate of return and actual rate base, net of productivity gain sharing

Over-earnings or Shortfalls to be included in rates will be included in the Revenue Cap as Exclusions according to the following formulas.

OE_{EXCt}	=	$-(OE_{t-1} * .75)$
SF_{EXCt}	=	$SF_{t-1} * .5$

Where:

OE_{EXCt}	=	Over-earnings Exclusion applied to Revenue Cap in rate year t.
OE_{t-1}	=	Over-earnings for year t-1 as calculated in review at end of year t-1.
SF_{EXCt}	=	Shortfall Exclusion applied to Revenue Cap in rate year t.
SF_{t-1}	=	Shortfall for year t-1 as calculated in review at end of year t-1.